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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1956.

No. 912

KREY PACKING COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit.

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To the United States Court of Appeals for the Eighth Circuit.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Krey Packing Company, a Missouri corporation, respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit in the cause styled "Krey Packing Company, Appellant v. United States of America, Appellee," affirming the judgment of the United States District Court for the Eastern Judicial District of Missouri, Eastern Division.

The opinion of the Court of Appeals is reported at 239 F. (2d) 1, and a copy thereof is appended. A memorandum of the District Court containing findings of fact and conclusions of law is reported at 138 F. Supp. 109, and a copy thereof is included in the record printed for the use of the Court of Appeals, nine copies of which are furnished pursuant to Rule 21.

JURISDICTION.

The judgment of the Court of Appeals was entered December 19, 1956. An order denying petition of appellant for rehearing was entered January 16, 1957. Jurisdiction of this court to review the judgment of the Court of Appeals is conferred by the Act of June 25, 1948, chapter 646, 62 Stat. 928, 28 U. S. C., Section 1254.

THE QUESTION PRESENTED.

The question presented is, whether a taxpayer using the LIFO ("Last-In-First-Out") method of inventorying goods who has suffered involuntary liquidation of inventory for a given taxable year and whose closing inventory for a subsequent taxable year reflects a replacement of the goods liquidated, in determining replacement cost of the goods liquidated, may use the **actual** replacement cost, or must use a fictional cost; and if the taxpayer must use a fictional cost, the method of determination thereof.

STATUTES INVOLVED.

The statute involved is the Internal Revenue Code of 1939, Section 22 (d) (6), as amended. The pertinent text of the above statute is appended.

STATEMENT OF THE CASE.

Petitioner is a Missouri corporation with offices in St. Louis, Missouri. The case was commenced in the District Court as an action to recover the sum of approximately $425,000 in federal income tax and excess profits tax alleged by petitioner to have been overpaid for its fiscal years ended October 31, 1943, 1944, and 1945. The District Court's jurisdiction was based upon the Act of June 25, 1948, c. 646, 62 Stat. 932, 28 U. S. C., Section 1340.

At all material times, petitioner was engaged in the business of buying, processing and selling principally pork and pork products. Petitioner has kept its books and records on the accrual basis of accounting and has filed each of its income and excess profits tax returns upon the basis of a fiscal year beginning November 1 and ending October 31.

For fiscal years ending in 1941 and thereafter, petitioner has used the LIFO method in inventorying goods pursuant to application duly made and granted under Section 22 (d). For the year ending in 1941 petitioner treated all goods included in opening inventory as having been acquired at the same time and determined their cost by the average cost method. For that year and each subsequent year it inventoried goods at cost and treated those goods remaining on hand at the close of the taxable year as being, first, those goods included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those goods acquired in the taxable year.

In determining the cost of goods which were acquired in the taxable year and were to be treated as included in goods on hand at the close of the taxable year, petitioner [in accordance with Section 29.22 (d)-2 of the Commission-

er's regulations] was entitled to use any one of the following methods:

(1) actual cost of goods most recently purchased;

(2) actual cost of goods purchased during the year in the order of acquisition;

(3) average unit cost of all goods purchased during the year; or

(4) any other proper method which, in the opinion of the Commissioner, would clearly reflect income.

For this purpose, in determining the price of goods acquired in the taxable year includible in the closing inventory, petitioner in fact elected on January 15, 1942, to use the actual cost of goods purchased during the year in the order of acquisition.

For each of the years ending in 1944 and 1945, petitioner's closing inventory reflected a decrease from the opening inventory. On the other hand, the closing inventories for each of the years ending in 1946, 1947, and 1948 reflected a partial replacement of the goods liquidated and not replaced in earlier years.

Petitioner duly elected the application of Section 22 (d)(6), and it is stipulated that the decreases in inventory in the years 1944 and 1945 were attributable to involuntary liquidations within the meaning of that statute; with the effect, also stipulated, that petitioner's net income for the years 1944 and 1945 is to be decreased by an amount equal to the excess, if any, of the aggregate "replacement cost" in 1946, 1947 and 1948 of the goods liquidated over the aggregate cost thereof reflected in opening inventory of the years of the involuntary liquidations.

The sole question in this case is, what is to be used as the replacement cost in 1946, 1947, and 1948 of the goods

liquidated in 1944 and 1945? Petitioner maintains that it is entitled to show that particular goods purchased in the years of replacement in fact replaced the goods previously liquidated, and to use the actual cost of such replacement goods as the replacement cost. Even assuming that the statute requires the use of a fictional rather than a real cost as the replacement cost, it is as much entitled to use the cost of goods **most recently** purchased in the years of replacement, that is, those goods purchased in the last months of the fiscal years, as some other fictional cost patterned after the Commissioner's LIFO regulations.

The Government maintains, and the courts below held, that petitioner must use the cost of the goods **first** purchased in the years of replacement. As both the actual cost of replacement goods and the cost of the goods purchased in the last months of the years of replacement are the same and are greater than the cost of the goods first purchased in those years, the amount by which petitioner's income for the years 1944 and 1945 is to be decreased is greater or less depending upon whether the position adopted by petitioner or the position adopted by the Government is correct. At the same time, income for the years of replacement is to be adjusted, as stipulated.

REASONS FOR ALLOWANCE OF THE WRIT.

This case presents important questions of federal law which have not been, but should be, settled by this court:

1. The proper interpretation of the term "replacement cost" as used in Section 22 (d) (6) (A) (ii) of the Internal Revenue Code of 1939, in providing for adjustment of tax in cases of replacement of goods involuntarily liquidated.

2. Whether Section 22 (d) (6), interpreted to require the use of a fictional cost as replacement cost, is in violation

of the due process clause of the Fifth Amendment to the Constitution of the United States, as being arbitrary and capricious.

3. Whether Section 22 (d) (6), interpreted to permit different bases for determination of replacement cost, depending upon which of several possible bases for determination of a different matter was elected by the taxpayer under another statute for a different purpose at a time prior to adoption of Section 22 (d) (6), is in violation of the due process clause of the Fifth Amendment as being both arbitrary and capricious and unjustifiably discriminatory.

4. Whether the decision in this case is so manifestly and flagrantly erroneous and the questions presented so little considered as to constitute a denial of the due process guaranteed by the Fifth Amendment.

ARGUMENT.

The statute, Section 22 (d) (6), in subparagraph (A) (ii), provides that income shall be decreased by the excess of replacement cost of liquidated goods over the inventory cost thereof. This case involves only application of that simple formula, and the only dispute in connection with application of the formula is over the meaning of "replacement cost."

The meaning, however, is quite plain. Replacement cost is *actual* cost of replacement. Proceeding on this premise petitioner sought, and the Government agreed, to stipulate petitioner's cost of replacement in the years 1946, 1947, and 1948, as demonstrated first, by the fact that in each of those years there was no replacement, but rather, further liquidation of inventory (whether voluntary or involuntary) until October, the last month of the fiscal year, and second, by the actual cost of the goods purchased in October.

The courts below, however, held in effect that such stipulation of actual cost of replacement was irrelevant. Their holdings were predicated upon rejection of the plain meaning of the statute in favor of another interpretation, an interpretation not founded upon orthodox aids to statutory construction such as regulations or legislative history, but rather upon a demonstrable fallacy in reasoning.

The courts reasoned as follows:

(i) Subsection 22 (d) deals generally with methods to be used in inventorying goods.

(ii) Paragraph (1) provides for use of a method which (at least as applied by petitioner) meant that the taxpayer in inventorying its goods at the close of the year was permitted to use a fiction, i. e., to treat the cost of goods

remaining on hand as being first, the cost of goods included in opening inventory in order of acquisition, and second, the cost of goods purchased during the year, also in order of acquisition.

(iii) Paragraph (6), added in 1942, like paragraph (1) is a part of subsection 22 (d), and applies only to taxpayers using the LIFO method of inventorying goods at the close of the year, as provided in paragraph (1).

(iv) Therefore, when paragraph (6) speaks of "replacement cost" in a later year of liquidated goods inventoried in an earlier year in accordance with the fictional LIFO method, it must mean a cost determined by use of a parallel fiction, i. e., by treating the cost of replacement as being the cost of goods purchased during the year of replacement in the order of acquisition.

Petitioner submits that the courts' conclusion does not at all follow from their premises. What the courts overlooked throughout are the simple facts that the determination required by paragraph (1) is **the inventory value of goods on hand at the close of the year**; that the LIFO method is prescribed for making this determination and this determination alone; that paragraph (6) calls for the completely distinct and wholly unrelated determination of **replacement cost of liquidated goods**; and that the statute does not, either expressly or by any reasonable implication, prescribe the LIFO method, or a method analogous thereto, or any other fictional method, or indeed any method at all for making this determination, the determination called for being simply and unmistakably the actual replacement cost of the goods in question.

The courts' confusion of the separate and distinct functions of paragraph 1 and paragraph 6 is evident from the opinion of the Court of Appeals:

> (1) "Taxpayer . . . argues that under the 1942 amendment it should be allowed to abandon the LIFO

method . . . We find no justification for such interpretation . . . The statute specifically provides that once the LIFO method is used it '. . . shall be used in all subsequent taxable years . . .' ". 239 F. (2d) 4.

But petitioner does not **wish** to "abandon" the LIFO method. The LIFO method is a method of inventorying goods at the close of the taxable year. That has nothing to do with this case. This case concerns a method of determining the cost of replacement in one year of goods liquidated in a previous year. True, the statute provides that the adoption of the LIFO method is irrevocable. But the **purpose** of adopting it is for inventorying goods at the close of the year, not for determining replacement cost of liquidated goods.

(2) "We believe that Congress intended the provisions of Section 22 (d) (6) relating to involuntary liquidation and replacement of inventory to operate in a manner consistent with the use by the taxpayer of the LIFO method in the replacement years . . . Congress . . . did not provide for a change in the method of valuation of inventories and that we cannot read into the statute." 239 F. (2d) 5.

But petitioner does not **seek** any change in the method of valuation of inventories, and there **is** no inconsistency between the manner of operation of Section 22 (d) (6) argued for by petitioner, and use of the LIFO method in the replacement years. Here the Court of Appeals seems to have believed that if actual cost of goods purchased in 1946 in replacement of goods liquidated in 1945, for example, were permitted to be used in determining "replacement cost" under the statute, it would necessarily follow that the same actual cost would have to be used in determining the value of such of the replacement goods as were included in closing inventory in 1946, and that since such a result would be inconsistent with the LIFO method of

determining the value of 1946 inventory, the use of actual cost could not be permitted for either purpose.

Such fear was wholly unfounded. It should have been dispelled by the statute itself, which in subparagraph 22 (d) (6) (C), quoted by the court, says that the goods constituting replacements in one year of goods involuntarily liquidated in an earlier year

> "'. . . shall be taken into purchases and included in the closing inventory of the taxpayer for the year of replacement **at the inventory cost basis of the goods replaced**' . . ." (emphasis supplied) 239 F. (2d) 4.

Thus this case presents important questions of federal law. There is the question, first, of the proper construction of Section 22 (d) (6), with respect to the meaning of "replacement cost." Does it mean actual cost of replacement, as we think abundantly clear, or does it mean a fictitional cost, as the courts below held?

There are, in addition, constitutional questions presented. Section 22 (d) (6), construed as it has been, is unconstitutional as in violation of the due process clause of the Fifth Amendment. It has been construed in such a way as to create in effect a conclusive presumption, that cost of goods first purchased in the years of replacement must be taken as the cost of replacement under the statute. This construction prevents petitioner from making proof of its actual cost of replacement of the liquidated goods. The statute so construed is arbitrary and capricious, and as such violates due process. **Tyler v. United States**, 281 U. S. 497 (1930); **Heiner v. Donnan**, 285 U. S. 312 (1932); **Manley v. Georgia**, 279 U. S. 577 (1929).

The courts' error was compounded when, after reasoning that "replacement cost" meant a fictional cost determined in accordance with LIFO method, they misunderstood that method.

The LIFO statute, Section 22 (d) (1), provides that the taxpayer in its closing inventory shall treat the cost of goods remaining on hand as being first, the cost of goods included in opening inventory in order of acquisition, and second, the cost of goods purchased during the year. This is as far as the statute goes. It does not provide the order in which **goods purchased during the year** shall be taken. It does **not**, as the courts seem to have believed, say that such goods also shall be taken in the order of acquisition. Thus where closing inventory exceeds opening inventory but does not equal the aggregate of opening inventory plus all purchases during the year, application of the statute requires that some, but not all, of the goods purchased during the year be treated as included in closing inventory, but the statute does not indicate **which** purchases shall be included.

The regulations, sec. 29.22 (d)-2, supply this omission. They provide that a taxpayer using the LIFO method may elect any one of several methods of determining which purchases during the year shall be included in closing inventory. These alternative methods include taking goods in the order of acquisition, but they **also** include taking the goods **most recently purchased.**

It is true that petitioner, in its particular application of the LIFO method of inventorying goods at the close of the year, elected to take that portion of the closing inventory representing purchases during the year at the cost of purchases in the order of their acquisition. But this is not to say that it was bound to so apply the LIFO method, or that such practice was inherent in the LIFO method, as the courts seem to have believed.

Thus, even assuming the correctness of the courts' premise that "replacement cost" means not actual cost but fictional cost determined per LIFO, it does not follow that the replacement goods must be found in the goods first purchased in the replacement years.

The decision of the Court of Appeals also gives critical effect to petitioner's election to use the LIFO method. 239 F. (2d) 5.

If the election referred to is merely the application to come under the statute, then the election has no rational bearing upon the determination of replacement cost, for the reasons stated above. On the other hand, it is possible that the election referred to by the court comprehends petitioner's selection (pursuant to the regulations) of a particular technique for application of the LIFO method. In such case the election is relevant only on the assumption that section 22 (d) (6) calls for determination of something other than actual replacement cost. In either event, however, what the court did was to make the decision in a case governed by a statute enacted in 1942 turn upon an election made by a taxpayer prior to the enactment of that statute and without reference to the provisions of that statute.

Now this, it is submitted, is likewise error which raises a constitutional question. The statute so construed gives detrimental effect to an election made under another statute and for another purpose, using such election as a basis for applying legislation subsequently enacted. This "shocks the sense of fair play—which is the essence of due process". **Galvan v. Press**, 347 U. S. 522 (1954). To point up the grievousness of the error, it may be supposed that a statute is passed imposing an additional surtax on taxpayers of a given class under certain circumstances, and a court construes the statute (even though the statute says nothing about it) in such a way that any taxpayer in the given class becomes subject thereto by virtue of having elected to adopt the LIFO method years before. Surely such a statute, so construed, would be unconstitutional.

The effect given to petitioner's LIFO election raises a further constitutional question in its discriminatory as-

pects. The situation of the petitioner may be compared with that of another taxpayer, otherwise similarly situated, who prior to adoption of Section 22 (d) (6) elected under the LIFO regulations to price purchases entering into closing inventory in the order of those most recently purchased. According to the court's reasoning in this case, such a taxpayer under Section 22 (d) (6) would be entitled to use cost of most recent purchases in years of replacement as "replacement cost" of liquidated goods.

So construed, the statute violates due process because of its unjustifiable discrimination. **Bolling v. Sharpe**, 347 U. S. 497 (1954). In another case involving this very statute it was recognized that a construction effectuating an unfair result should be avoided. **Pizitz Dry Goods Co., Inc. v. Deal et al.**, 208 F. (2d) 724 (5th Cir., 1953).

The questions of federal law raised by this case, then, include the question of interpretation of an important tax statute, and constitutional questions arising from the Court of Appeals' interpretation. In addition, there is a violation of due process implicit in the decision itself. There is error in rejecting the plain meaning of the statute, with the consequence that petitioner was precluded from effectively stipulating obviously relevant facts. There is error in the court's understanding of the LIFO method, with the consequence that effect was improperly given to an election made to adopt that method or to an election made incident to application of that method. It is submitted that decisional error (to paraphrase Mr. Justice Holmes) can be so gross as to be irreconcilable with a rational administration of justice. cf. **Chicago Life Insurance Co. v. Cherry**, 244 U. S. 25, 30 (1917).

Wherefore, your petitioner respectfully prays that a writ of certiorari be issued by this Court, directed to the United States Court of Appeals for the Eighth Circuit,

ordering that Court to certify and to send to this Court for its review and determination, on a day certain to be named in said writ, a full and complete transcript of the record and all proceedings in the case of **Krey Packing Company, Appellant, v. United States of America, Appellee,** docket No. 15,545; that the judgment of the Court of Appeals be reversed; and that your petitioner may have such other and further relief as to this honorable Court may seem just.

Respectfully submitted,

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APPENDIX.

OPINION OF THE COURT OF APPEALS.

Krey Packing Company,
Appellant,

v.

United States of America,
Appellee.

No. 15545.

United States Court of Appeals,
Eighth Circuit.

Dec. 19, 1956.

Rehearing Denied Jan. 16, 1957.

Henry C. Lowenhaupt, St. Louis, Mo. (Abraham Lowenhaupt and Lowenhaupt, Mattingly, Chasnoff, Freeman & Holland, St. Louis, Mo., were with him on the brief), for appellant.

Harry Marselli, Washington, D. C. (Charles K. Rice, Asst. Atty. Gen., Lee A. Jackson and Walter Akerman, Jr., Attorneys, Dept. of Justice, Washington, D. C., and Harry Richards, U. S. Atty., St. Louis, Mo., were with him on the brief), for appellee.

Before Woodrough, Vogel and Van Oosterhout, Circuit Judges.

Vogel, Circuit Judge.

The taxpayer, Krey Packing Company, brought this suit to recover income and excess profits taxes. From an adverse result plaintiff appeals to this court. The facts are not in dispute. Plaintiff is a Missouri corporation engaged

in the operation of a slaughter house and processing plant in St. Louis, Missouri. It is engaged principally in the processing of pork products. The question presented is the proper cost attributable to items of inventory purchased by plaintiff in replacement of items of inventory acquired under the LIFO method prescribed by 26 U. S. C. A. (I. R. C. 1939) 22 (d) (1), and which were involuntarily liquidated within the meaning of 26 U. S. C. A. (I. R. C.) 22 (d) (6) (B). Plaintiff asserts by its petition that the proper cost of such items is the cost of the items last purchased in the fiscal year which it asserts is the actual cost thereof, and defendant asserts that the proper cost is the cost of such items first purchased in the fiscal year.

Plaintiff kept its books and records on the accrual basis of accounting and filed its tax returns on the basis of a fiscal year commencing November 1st.

26 U. S. C. A. (I. R. C. 1939), § 22 (d) (1), provides for the elective or LIFO (last in-first out) method of inventory valuation:

> "(d) **Method of inventorying goods.** (1) A taxpayer may use the following method [whether or not such method has been prescribed under subsection (c)] in inventorying goods specified in the application required under paragraph (2):
>
> "(A) Inventory them at cost;
>
> "(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and, second, those acquired in the taxable year; and
>
> "(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method."

On January 15, 1942, plaintiff filed with the Collector of Internal Revenue its return for the preceding fiscal year and attached Form 970, thereby making application to use the LIFO method of valuing inventories of pork and pork products. Such application was granted. Plaintiff has used such method of inventorying goods in all taxable years subsequent to the fiscal year ending October 31, 1940.

During the fiscal years ending October 31, 1944, and October 31, 1945, plaintiff suffered involuntary liquidations of its inventories.[1] Plaintiff's failure to replace the goods was due directly and exclusively to the then prevailing war conditions beyond the control of the plaintiff and to material shortages resulting from priorities or allocations. The inventories so involuntarily liquidated were largely replaced in the fiscal years ending October 31, 1946, 1947 and 1948. Plaintiff contends that the proper cost attributable to items of inventory purchased in replacement of the items involuntarily liquidated during the fiscal years 1944 and 1945 is represented by the cost of the items last purchased in the respective years of replacement. A substantial tax benefit would result if plaintiff is correct.

[1, 2] Defendant contends that the proper cost attributable to items of inventory purchased by plaintiff in replacement of LIFO inventory items involuntarily liquidated during the fiscal years of 1944 and 1945 is represented by the

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1 26 U. S. C. A., § 22 (d) (6) (B), provides:

"**Definition of involuntary liquidation.** The term 'involuntary liquidation,' as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer."

cost of such items first purchased in the order of acquisition in the respective years of replacement. If the latter view prevails, the District Court committed no error in holding for the defendant, and this appeal should be affirmed. The question presented on this appeal, then, is whether the District Court was correct in holding that the cost of items of inventory purchased by a taxpayer using the LIFO method of valuing inventory provided by Section 22 (d) (1) of the 1939 Code in replacement of inventory involuntarily liquidated within the meaning of Section 22 (d) (6) was properly determined by reference to the cost of the items of inventory purchased during the respective years of replacement in the order of their acquisition and not by reference to the cost of the goods last acquired in such years.

Prior to the passage of Section 22 (d) (1), which provided for the LIFO method of inventory valuation, the usual way of determining inventory cost was on the first-in, first-out basis; that is, goods on hand were deemed to be those most recently purchased. Under this method and during a period of rising prices, large profits would be shown because goods which had actually been purchased at low price levels were being sold at much higher prices, but at the same time inventories would have to be replenished at the prevailing high prices. Lower profits or losses would be shown on a declining market. In order to avoid great fluctuations in income during such unstable periods, Congress passed Section 22 (d) whereby a taxpayer could apply for and receive permission to use the valuation method therein provided. After permission had been received a taxpayer had to continuously use the method thereafter in all subsequent years, unless he applied for and received permission to change to a different method. No such request was made here. Under ordinary circumstances, users of the LIFO method were able to replace their inventories at current prices. During the war years, however, difficulty was ex-

perienced where inventories were involuntarily liquidated and taxpayers were unable to replace them at the then prevailing prices. Taxpayers were being forced to involuntarily liquidate low cost inventories at a time when it was impossible to replace them. The result was a greater tax burden than was contemplated by the Congress in providing for the use of the LIFO method of inventory valuation. Accordingly, in 1942 Congress was moved to grant relief from the tax consequences of involuntary liquidation by passing Section 22 (d) (6), which provides, insofar as it may be pertinent herein, as follows:

"(6) **Involuntary liquidation and replacement of inventory.**

"(A) **Adjustment of net income and resulting tax.** If, for any taxable year beginning after December 31, 1940, and prior to January 1, 1948, the closing inventory of a taxpayer inventorying goods under the method provided in this subsection reflects a decrease from the opening inventory of such goods for such year, * * * and if the closing inventory of a subsequent taxable year, ending prior to January 1, 1951, reflects a replacement, in whole or in part, of the goods so previously liquidated, the net income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be adjusted as follows:

* * * * * * *

"(ii) Decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation.

* * * * * * *

"(C) **Replacements.** If, in the case of any taxpayer subject to the provisions of subparagraph (A), the closing inventory of the taxpayer for a taxable year,

subsequent to the year of involuntary liquidation but prior to the complete replacement of the goods so liquidated, reflects an increase over the opening inventory of such goods for the taxable year, the goods reflecting such increase shall be considered, in the order of their acquisition, as having been acquired in replacement of the goods most recently liquidated (whether or not in a year of involuntary liquidation) and not previously replaced, and if the liquidation was an involuntary liquidation shall be taken into purchases and included in the closing inventory of the taxpayer for the year of replacement at the inventory cost basis of the goods replaced." 26 U. S. C. A. (I. R. C. 1939), § 22 (d) (6) (A) and (C).

This 1942 amendment was applicable only to taxpayers "* * * inventorying goods under the method provided in this subsection * * *"; in other words, only to those taxpayers using the LIFO method of valuation. If a taxpayer elected to have the provisions of the 1942 amendment apply to his situation and he replaced inventories, involuntarily liquidated, at higher prices, he received an adjustment on his net income for the year of such involuntary liquidation in that it would be "(ii) Decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation." 26 U. S. C. A. (I. R. C. 1939), § 22 (d) (6) (A) (ii).

Taxpayer here, however, would go farther than the strict provisions of the 1942 amendment allow, in that it argues that under the 1942 amendment it should be allowed to abandon the LIFO method and use as a base the cost of goods last purchased in the replacement years because it claims the actual replacement cost and not the fictional LIFO cost should be the basis of computation. We find no justification for such interpretation of the 1942 amendment.

The statute specifically provides that once the LIFO method is used it "* * * shall be used in all subsequent taxable years * * *." 26 U. S. C. A. (I. R. C. 1939), § 22 (d) (5). Doubtless plaintiff would concede the obvious meaning of this statute compelling continuance of LIFO once adopted but contends this to be beside the point since it claims the 1942 amendment provides an escape from the use of it. If Congress had so intended by the amendment that users of the LIFO method could abandon such method insofar as the years of involuntary liquidation were concerned, it would have said so.[2]

We believe that Congress intended the provisions of Section 22 (d) (6) relating to involuntary liquidation and replacement of inventory to operate in a manner consistent with the use by the taxpayer of the LIFO method in the replacement years. It is significant that the section referred to is applicable only to LIFO users and it therefore seems

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2 The best expression of Congressional intent, when available, is from the Congress itself. In this connection the Senate Finance Committee Report states (pp. 43-44, 82):

"Relief for Taxpayers Employing Last-in First-out Method of Inventory Valuation in Event of Forced Inventory Liquidation.

"Your committee amendment provides that if the taxpayer using the last-in first-out method of inventory valuation satisfactorily establishes the involuntary nature of his inventory liquidation, and if he replaces such units at least by the end of the third year after cessation of hostilities, his taxable income should be redetermined for such year or years of involuntary liquidation. His taxable income in such year or years would be reduced or increased, depending on whether the replacement cost was greater or less than the cost of the liquidated inventory units. In other words, the taxpayer is treated as if subsequent replacements of involuntary liquidated inventory units had been made in the year of liquidation.

* * * * * * *

"Section 119. Last-In, First-Out Inventory.

"In this new section of the bill your committee proposes to afford to taxpayers using the elective inventory method authorized by section 22 (d) of the Code a measure of relief from the consequences of the involuntary liquidation of their base stock inventory resulting from prevailing war conditions. * * *"

There is nothing here that indicates LIFO may be abandoned. To the contrary, it would seem that the amendment was meant to correlate relief with continued usage of LIFO. The relief contemplated is set out in Section 22 (d) (6) (A) (ii) without hint that such relief is to be arrived at any other way than through use of the LIFO method.

clear to us that if Congress had intended to relieve LIFO users from the statutorily imposed consistency in its use, heretofore referred to, it would have made special provision therefor in the amendment. By Section 22 (d) (6) Congress provided relief in the form of credits against net income for the years of involuntary liquidation. It did not provide for a change in the method of valuation of inventories and that we cannot read into the statute.

We find, then, this situation: Plaintiff voluntarily elected to use the LIFO method in 1942, it apparently being beneficial for it so to do under the circumstances then existing. It received the necessary permission to use LIFO. In other words, it went on a fictional as opposed to an actual method of evaluating inventory. Plaintiff now seeks to change its method of inventory valuation insofar as replacement of involuntarily liquidated inventories is concerned, even though it was using the LIFO method during the years of involuntary liquidation and continues to use the LIFO method and at no time has ever applied for and received permission to change such method. We find nothing in the 1942 amendment applying to replacements of involuntarily liquidated inventories which justifies plaintiff's interpretation thereof. Plaintiff here fails to overcome the burden placed on it by "* * * the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer. New Colonial Ice Co. v. Helvering, 292 U. S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348; Deputy v. Dupont, 308 U. S. 488, 493, 60 S. Ct. 363, 366, 84 L. Ed. 416." Interstate Transit Lines v. Commissioner of Internal Revenue, 1943, 319 U. S. 590, 593, 63 S. Ct. 1279, 1281, 87 L. Ed. 1607. We concur with the District Judge's opinion, Krey Packing Co. v. United States, D. C., 138 F. Supp. 109.

Affirmed.

TEXT OF STATUTE INVOLVED.

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

* * * * * * *

(d) [As amended by Sec. 219 (a), Revenue Act of 1939, c. 247, 53 Stat. 862].

(6) [As added by Sec. 119, Revenue Act of 1942, supra, and amended by Sec. 110 (a), Revenue Act of 1943, c. 63, 58 Stat. 21, Sec. 1 (a), Act of September 5, 1950, c. 851, 64 Stat. 592, and Sec. 1 (a) and (b), Act of January 11, 1951, c. 1227, 64 Stat. 1244]. **Involuntary liquidation and replacement of inventory.—**

(A) **Adjustment of Net Income and Resulting Tax.—Years beginning prior to January 1, 1948.** If, for any taxable year beginning after December 31, 1940, and prior to January 1, 1948, the closing inventory of a taxpayer inventorying goods under the method provided in this subsection reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects, at such time and in such manner and subject to such regulations as the Commissioner with the approval of the Secretary may prescribe, to have the provisions of this paragraph apply, and if it [is] established to the satisfaction of the Commissioner, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in subparagraph (B), and if the closing inventory of a subsequent taxable

year, ending prior to January 1, 1953, reflects a replacement, in whole or in part, of the goods so previously liquidated, the net income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be adjusted as follows:

(i) Increased by an amount equal to the excess, if any, of the aggregate cost of such goods reflected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost; or

(ii) Decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation.

The taxes imposed by this chapter and by chapter 2 for the year of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting should be credited or refunded to the taxpayer without interest.

(B) **Definition of Involuntary Liquidation.**— The term "involuntary liquidation," as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either

voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(C) **Replacements.**—If, in the case of any taxpayer subject to the provisions of subparagraph (A), the closing inventory of the taxpayer for a taxable year, subsequent to the year of involuntary liquidation, but prior to the complete replacement of the goods so liquidated, reflects an increase over the opening inventory of such goods for the taxable year, the goods reflecting such increase shall be considered, in the order of their acquisition, as having been acquired in replacement of the goods most recently liquidated (whether or not in a year of involuntary liquidation) and not previously replaced, and if the liquidation was an involuntary liquidation shall be taken into purchases and included in the closing inventory of the taxpayer for the year of replacement at the inventory cost basis of the goods replaced.

(D) **Election Irrevocable.**—An election by the taxpayer to have the provisions of this paragraph apply, once made, shall be irrevocable and shall be binding for the year of the involuntary liquidation and for all determinations for prior and subsequent taxable years insofar as they are related to the year of liquidation or replacement.

* * * * * * * *

(26 U. S. C., 1952 Ed., Sec. 22.)

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 912

KREY PACKING COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 45-53)[1] is reported at 138 F. Supp. 109. The opinion of the Court of Appeals (Pet. 15-22) is reported at 239 F. 2d 1.

JURISDICTION

The judgment of the Court of Appeals was entered on December 19, 1956, and a petition for rehearing was denied on January 16, 1957. (Pet. 15.) The

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[1] Record references are to the printed record filed in the Court of Appeals.

petition for a writ of certiorari was filed on April 15, 1957. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the Court of Appeals was correct in affirming the District Court's holding that the cost of inventory items purchased by a taxpayer using the LIFO method of valuing inventory to replace inventory involuntarily liquidated within the meaning of Section 22(d)(6) of the Internal Revenue Code of 1939, was properly determined by reference to the cost of the items of inventory purchased during the respective years of replacement in the order of their acquisition and not by reference to the cost of items last acquired in such years.

STATUTE AND REGULATIONS INVOLVED

Section 22 (c) and (d) of the Internal Revenue Code of 1939 and Sections 29.22(d)-1, 29.22(d)-2, 29.22(d)-5, and 29.22(d)-7 of Treasury Regulations 111 are set forth in the Appendix, *infra*, pp. 8-18

STATEMENT

The facts, which were developed entirely by stipulation (R. 33-43) and were adopted by the trial court as stipulated (R. 45-48), may be summarized as follows:

The taxpayer is a Missouri corporation which, during the years involved, operated a slaughter house and processing plant in St. Louis, and was engaged principally in the processing of pork products. It

kept its books and records on the accrual basis of accounting and filed its income and excess profits tax returns upon the basis of a fiscal year commencing November 1. (R. 33, 34.)

On January 15, 1942, the taxpayer duly applied for permission to use the LIFO ("last in, first out") method of valuing its inventory of pork and pork products, under the provisions of Section 22(d) of the Internal Revenue Code of 1939, which permission was granted. The taxpayer used and has used the LIFO method of inventorying goods in all taxable years subsequent to the taxable year ended October 31, 1940. (R. 34.)

During the fiscal years ended October 31, 1944, and October 31, 1945, the taxpayer suffered involuntary reductions in its inventories resulting from the sale in the course of its business of goods inventoried under the LIFO method which it failed to replace due directly and exclusively to war conditions beyond its control or to material shortages resulting from priorities or allocations. These reductions constituted involuntary liquidations within the meaning of Section 22(d)(6) of the Internal Revenue Code of 1939, and the taxpayer duly elected to have the provisions of that section apply. (R. 34-36.)

The inventory involuntarily liquidated was largely replaced in the fiscal years ended October 31, 1946, 1947 and 1948. (R. 36.)

The Commissioner of Internal Revenue made a determination of the taxpayer's income and excess profits tax liability for several years, including those involved here (R. 10-11), in which adjustments were

made as to the fiscal years ended October 31, 1944, and October 31, 1945, to reflect the replacement of the inventories involuntarily liquidated in those years (R. 19, 23). The adjustments were made on a basis which attributed a cost to the items of inventory acquired in replacement of the inventory items involuntarily liquidated represented by the cost of such items purchased in the order of acquisition in the respective years of replacement. (R. 37.)

The taxpayer filed claims for refund of taxes paid with respect to the taxable years 1943, 1944 and 1945, which were duly disallowed by the Commissioner (R. 37-39), and thereupon timely instituted this suit for refund of 1943 and 1944 income and excess profits taxes in the respective total amounts of $261,783.91 and $58,737.35 and of 1945 income taxes in the amount of $93,114.67. (R. 7, 8, 9.)

The refunds claimed by the taxpayer are founded upon its contention that the proper cost attributable to items of inventory purchased in replacement of the items involuntarily liquidated during the fiscal years 1944 and 1945 is represented by the cost of the items last purchased in the respective years of replacement. (R. 4-6, 36.) Based upon the cost of goods last purchased, the excess of the actual cost of the goods purchased in replacement over the original inventory value of the goods involuntarily liquidated would amount to $439,942.97 and would be attributable to 1944 in the amount of $84,690.67 and to 1945 in the amount of $355,252.30. (R. 36.)

The district court sustained the Commissioner's method of determining the cost of the replacement

items of inventory involuntarily liquidated and entered judgment accordingly. (R. 45-53.) The Court of Appeals affirmed. (Pet. 15-22.)

ARGUMENT

1. This case presents a narrow and complex issue of tax accounting arising under the so-called LIFO (last-in, first-out) inventory method, an elective method of valuing inventory permitted by Section 22(d) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 8-11). Under Section 22(d)(6), a taxpayer who elected to use the LIFO method and sustained an "involuntary liquidation" of inventory in a taxable year between 1941 and 1947, *i.e.*, was unable by reason of "prevailing war conditions" to replace liquidated inventory until a later year, could also elect to make an income adjustment for the year of liquidation measured by the difference between the "aggregate replacement cost" and the original inventory cost. Under paragraph (C) of Section 22(d)(6), goods subsequently purchased to replace liquidated items of inventory are deemed to have been purchased "in the order of their acquisition" and in replacement of the goods most recently liquidated. See also Section 29.22(d)-7 of Treasury Regulations 111 (Appendix, *infra*, pp. 14-18). Taxpayer elected to use the LIFO inventory method during the taxable years here involved (fiscal years 1944 and 1945), and also elected to invoke the involuntary liquidation provisions of Section 22(d)(6).

Both courts below, approving the Commissioner's determination, held that under the LIFO method of

valuing inventory the cost of goods purchased by the taxpayer in replacement of inventory involuntarily liquidated within the meaning of Section 22(d)(6) is properly computed by reference to the cost of inventory items purchased during the respective years of replacement in the order of their acquisition, and not by reference to the cost of items last purchased during the replacement years. This conclusion, as both courts below demonstrated, is in harmony with the applicable statutory provisions, their legislative history, and the Treasury Regulations. The decision below correctly requires a taxpayer using the LIFO inventory method to account for the cost of goods acquired in replacement of inventory involuntarily liquidated in a manner consistent with the use of that method and the requirements of Section 22(d)(6).

2. There is no conflict of decisions, nor is any conflict asserted. This case admittedly is one of first impression.

3. Contrary to taxpayer's assertions (Pet. 5-6, 10-13), no constitutional question is presented. The issue is solely one of statutory construction and, as both courts below pointed out, taxpayer's contentions are predicated upon an erroneous interpretation of the statute.

4. The question presented is not one of general importance. By its terms Section 22(d)(6) affects a limited class of taxpayers—those whose income is determined on an inventory basis, and who elect to adopt both the LIFO method provided in Section 22(d)(1) and the involuntary liquidation provisions of Section 22(d)(6). Moreover, the issue here pre-

sented can arise only with respect to the war years specified in paragraph (A) and in the special circumstances enumerated in paragraph (B) of Section 22 (d) (6), *i.e.*, where the taxpayer was unable to replace inventory involuntarily liquidated between 1941 and 1947 by reason of "prevailing war conditions beyond the control of the taxpayer".[2] The issue presented should therefore seldom, if ever, recur.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
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CHARLES K. RICE,
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WALTER AKERMAN, JR.,
Attorneys.

MAY 1957.

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[2] Section 22(d)(6) was added to the 1939 Code by Section 119 of the Revenue Act of 1942, c. 619, 56 Stat. 798. It was designed "to afford to taxpayers using the elective inventory method authorized by Section 22(d) of the Code a measure of relief from the consequences of the involuntary liquidation of their base stock inventory resulting from prevailing war conditions". S. Rep. No. 1631, 77th Cong., 2d Sess., p. 82 (1942-2 Cum. Bull. 504, 567). See also Section 1321 of the Internal Revenue Code of 1954, affording similar limited elective relief as to involuntary inventory liquidations of LIFO inventories resulting from the Korean War conditions.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(d) [As amended by Sec. 219(a), Revenue Act of 1939, c. 247, 53 Stat. 862] (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; * * *

* * * *

(5) If a taxpayer, having complied with paragraph (2), uses the method described in paragraph (1) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(A) With the approval of the Commissioner a change to a different method is authorized; * * *

* * * *

(6) [As added by Sec. 119, Revenue Act of 1942, c. 619, 56 Stat. 798; and amended by Sec. 110(a), Revenue Act of 1943, c. 63, 58 Stat. 21, Sec. 1(a), Act of September 5, 1950, c. 851, 64 Stat. 592, and Sec. 1(a) and (b), Act of January 11, 1951, c. 1227, 64 Stat. 1244] *Involuntary liquidation and replacement of inventory.*—

(A) *Adjustment of Net Income and Resulting Tax.—Years beginning prior to January 1, 1948.* If, for any taxable year beginning after December 31, 1940, and prior to January 1, 1948, the closing inventory of a taxpayer inventorying goods under the method provided in this subsection reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects, at such time and in such manner and subject to such regulations as the Commissioner with the approval of the Secretary may prescribe, to have the provisions of this paragraph apply, and if it [is] established to the satisfaction of the Commissioner, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in subparagraph (B), and if the closing inventory of a subsequent taxable year, ending prior to January 1, 1953, reflects a replacement, in whole or in part, of the goods so previously liquidated, the net income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be adjusted as follows:

(i) Increased by an amount equal to the excess, if any, of the aggregate cost of such goods re-

flected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost; or

(ii) Decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation.

The taxes imposed by this chapter and by chapter 2 for the year of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting should be credited or refunded to the taxpayer without interest.

(B) *Definition of Involuntary Liquidation.*—The term "involuntary liquidation", as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control

of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(C) *Replacements.*—If, in the case of any taxpayer subject to the provisions of subparagraph (A), the closing inventory of the taxpayer for a taxable year, subsequent to the year of involuntary liquidation but prior to the complete replacement of the goods so liquidated, reflects an increase over the opening inventory of such goods for the taxable year, the goods reflecting such increase shall be considered, in the order of their acquisition, as having been acquired in replacement of the goods most recently liquidated (whether or not in a year of involuntary liquidation) and not previously replaced, and if the liquidation was an involuntary liquidation shall be taken into purchases and included in the closing inventory of the taxpayer for the year of replacement at the inventory cost basis of the goods replaced.

(D) *Election Irrevocable.*—An election by the taxpayer to have the provisions of this paragraph apply, once made, shall be irrevocable and shall be binding for the year of the involuntary liquidation and for all determinations for prior and subsequent taxable years insofar as they are related to the year of liquidation or replacement.

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.22(d)-1. *Inventories Under Elective Method.*—Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22(c), and pursuant to the provisions of sections 29.22(c)-1 to 29.22(c)-8, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22(d). Under this elective inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:
>
> > First, those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and
> >
> > Second, those acquired during the taxable year.
>
> This elective inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.
>
> SEC. 29.22(d)-2 [As amended by T.D. 5504, 1946-1 Cum. Bull. 52, and T.D. 5756, 1949-2 Cum. Bull. 21]. *Requirements Incident to Adoption and Use of Elective Method.*—Except as otherwise provided in section 29.22(d)-1 with respect to raw material computations, with respect to retail inventory computations, and with respect to "dollar-value" and other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 22(d), the adoption and use of the elective inventory method is, by section 22(d) and the regulations thereunder, made subject to the following requirements:

(1) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied;

* * * *

(4) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of rule (A) or rule (B) hereof, dependent upon the character of the transactions in which the taxpayer is engaged;

Rule (A). In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the *initial* production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

* * * *

Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the elective inventory method is used by the taxpayer;

* * * *

SEC. 29.22(d)-5. *Revocation of Election.*—An election made to adopt and use the elective inventory method is irrevocable, and the method

once adopted shall be used in all subsequent taxable years, unless the use of another method be required by the Commissioner, or authorized by him pursuant to a written application therefor filed with him as provided in section 29.41-2.

SEC. 29.22(d)-7 [As amended by T. D. 5364, 1944 Cum. Bull. 86, T. D. 5645, 1948-2 Cum. Bull. 14, T. D. 5841, 1951-1 Cum. Bull. 11, and T. D. 5932, 1952-2 Cum. Bull. 76]. *Involuntary Liquidation and Replacement.*—If prevailing war conditions beyond the control of the taxpayer, or certain prescribed postwar conditions beyond his control, should render it impossible either during the period of the war or within the prescribed postwar period for a taxpayer using the elective inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner at any time not later than 6 months after the time of filing his income tax return for the year of the liquidation, or at any time not later than December 15, 1952, in the case of the year of liquidation being a taxable year ending after June 30, 1950, and before March 1, 1952, that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 22(d)(6), and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, to an adjustment of net income for the year of liquidation to the extent of the difference between the replacement costs incurred and the original inven-

tory cost of the base stock inventory liquidated. * * *. If the replacement costs exceed such inventory costs, the net income of the taxpayer otherwise computed shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, net income otherwise computed shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected by the Commissioner or credited or refunded to the taxpayer without interest.

The statutory provisions affording recognition to the involuntary character of inventory decreases which become apparent in war years and authorizing for tax purposes a replacement of the items of merchandise so liquidated are limited in their application to liquidations occurring in taxable years beginning prior to January 1, 1948, and to inventory replacements effected in taxable years ending prior to January 1, 1953. * * *.

With respect to inventory decreases occurring during the period of the war, a failure on the part of the taxpayer to have on hand in his closing inventory for the taxable year merchandise of the kind, description, and quantity of that reflected in his opening inventory will be considered as an involuntary liquidation only if it is established to the satisfaction of the Commissioner that such failure is due wholly to his inability to purchase, manufacture, or otherwise produce and procure delivery of such merchandise during the taxable year of liquidation by reason of prevailing war conditions, such as (i) enemy capture or control of sources of limited foreign supply; (ii) shipping or other transportation shortages; (iii) material shortages resulting from priorities or allocations; (iv) labor shortages; and (v) similar war conditions beyond the control of the taxpayer. A voluntary

shift by the taxpayer, in the exercise of business judgment, to merchandise of a different character, description, or use, or to merchandise processed out of a substantially different kind of raw materials while raw materials of the type originally used are still available will not be considered as an involuntary liquidation notwithstanding the fact that such a shift in merchandise stocked was prompted by a shifting market demand attributable to war conditions. The term "involuntary liquidation" presupposes a physical inability to maintain a normal inventory as distinguished from a financial or business disinclination on the part of the taxpayer to do so.

* * * *

If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decrease, he must so elect within the time prescribed by these regulations. In making such election, the taxpayer shall attach to his return and make a part thereof, or he shall furnish separately to the Commissioner, a statement setting forth the following matters; (1) the wish of the taxpayer to invoke the involuntary liquidation and replacement provisions; (2) a detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended; (3) the circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved, including evidence of the applicable National Production Authority inventory control figures for the beginning and the close of the taxable year (or if none, a statement to that effect), allotments applied for, allotments received, and reason for failure to place allotments received; (4) detailed proof of such circumstances to the extent that they may not be the subject-matter of common knowledge; (5) a full description of what efforts were made on

the part of the taxpayer to effect replacement during the taxable year and the result of such efforts; * * *.

The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease, and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its replacement, and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening and subsequent years to the extent that such prior, intervening and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carry-backs, and in intervening and subsequent taxable years by reason of adjustments in carry-overs. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's returns for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized.

Notwithstanding the ultimate purchase price or the cost of production ultimately incurred by the taxpayer in effecting replacement of a stock involuntarily liquidated, the merchandise reflecting the replacement shall be taken into pur-

chases and included in the closing inventory for the year of replacement, and shall be included in the inventories of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

The goods reflected in any inventory increase in a year subsequent to a year of involuntary liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced; * * *. To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

* * * *

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